Postal Regulatory Commission
Submitted 1/31/2014 3:56:16 PM
Filing ID: 89090
Accepted 1/31/2014

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2013	)	Docket No. ACR2013

INITIAL COMMENTS OF THE
AMERICAN CATALOG MAILERS ASSOCIATION (ACMA)

(January 31, 2014)

Pursuant to Commission Order No. 1935 (December 10, 2013), ACMA is pleased to sponsor these comments, along with ACMA_ACR2013_Workbook.xlsx.

Introduction. **C**atalogs make a wide range of goods and services available, many of which are difficult to find. They provide information, are valued by recipients, and often serve as resource documents. Catalogs are a major component of the Standard Mail class, and they are linked to other mail categories. On average, they spend 54 percent of their marketing budgets on postage,[1] a proportion that has increased over time. Rates for catalogs, then, are critically important to catalogers, recipients, and the Postal Service.

[1] ACMA unpublished Survey of Member Mail Use, 2012.

Use of the Mail. Generally, catalogs are classified as "flats" and are sent via Commercial flats categories of Standard Mail. The volumes in these categories depend on the automation and density characteristics of the mailings that use them. In a mailing, High-Density rates apply to pieces to routes getting 125 or more pieces. Carrier Route rates apply to pieces to routes getting 10 or more pieces. Short of these two, categories exist for 5-digit prep(aration), 3-digit prep, ADC prep, and Mixed ADC prep. Of the flats in all six categories, 90.5 percent received a dropship discount in FY 2013. In order, the volume proportions among them are 9.1 percent, 60.3 percent, 20.8 percent, 8.5 percent, 0.8 percent, and 0.6 percent.[2] Together, these categories form a continuum. Most mailings are split among several categories.

In reporting, these categories show up as parts of three Commercial+Nonprofit collections that have been designated as products—

(1) Standard Flats,

(2) Carrier Route, and

(3) High Density, High-Density Plus, and Saturation, Flats and Parcels.[3]

---

[2] This breakdown does not include flats in the Commercial categories of High-Density Plus and Saturation, both used in negligible degree by catalogs.

[3] Table VII-16, FY2012 ACD at 106 shows data for these products, on separate lines.

Not counting Saturation, High-Density Plus, or the dropship options, Commercial flats fall into 10 categories [10 = 2 automation options x 4 sortation options + 2 additional sortation categories (Carrier Route and High-Density)]. Similarly, Nonprofit flats fall into another 10 categories.

These 20 categories are parts of three designated products. The first product is Standard Flats {a collection of 16 categories [2 (Commercial and Nonprofit) x 2 (automation and non-automation) x 4 (Mixed ADC, ADC, 3-digit, and 5-digit)]}. The second product is Carrier Route {a collection of 6 categories [2 (Commercial and Nonprofit) x 3 (letter, flat, and parcel)]}. The third product is High-Density and Saturation Flats and Parcels {a collection of 12 categories

*** footnote continued next page

As a practical matter, the law allows considerable leeway in product designations.[4]

I. POSITION OF ACMA IN THIS PROCEEDING

In the Standard Mail class, excluding Saturation and High-Density Plus, the Standard Flats product houses 30.7 percent of the Commercial flats and 55.4 percent of the Nonprofit flats.[5] An increase in rates for Standard Flats, then, impacts disproportionately the flats of nonprofit organizations. Most of the 30.7-percent figure is catalogs. Both of these percentages are declining due to co-mailing and associated dropship activities, though probably in lesser degree for Nonprofit. Except for small mailers, Standard Flats is a declining category of residual mail to relatively remote areas and mail not integrated into printing and distribution schemes.

As defined, then, Standard Flats is an odd concoction. It is composed of mail that, due to volume limitations, cannot be presorted more finely than a 5-digit area, as

---

footnote continued

[2 (Commercial and Nonprofit) x 3 (High-Density, High-Density Plus, and Saturation) x 2 (flat and parcel)]}.

Thus, though the 10 categories used by Commercial catalogers fall into 3 products, those products house other categories as well, some disparate.

[4] Section 102(6) of 39 U.S.C. states that the term "product" is "used" to "mean[ ] a postal service with a distinct cost or market characteristic for which a rate or rates are, or may reasonably be, applied." Therefore, a reference in the law to a "product" means such a category, whether or not it has been designated as a product and whether or not a separate rate for it exists. Accordingly, it is clear that the law countenances almost any product breakdown and supports none as being constrained or meriting special attention.

Indeed the Commission has indicated that "the term 'product' in section 102(6) is so general … that almost any category of mail nominated would qualify" (Order No. 536, Docket No. RM2009-3, September 14, 2010 at 22).

[5] These proportions are calculated from the billing determinants in USPS LR-4.

though the notion of a 5-digit area were pertinent. The notion is not. Five-digit areas vary significantly in terms of geographic size, population, demographics, and affluence, the latter factor being an important volume determinant. Viewed another way, Standard Flats is composed of mail that simply cannot reach the 10-piece threshold for Carrier Route. In short, the definition of the Standard Flats product is not particularly meaningful.

Yet for all this, Standard Flats is being costed separately, and concern exists that its revenues are below its costs. ACMA's position, as supported further below, including that serious questions exist about the validity of the costs, is that special concern about the level of the rates for Standard Flats is not warranted by the cost coverage. The rates for Standard Flats are part of a *schedule* of rates presented to mailers by the Postal Service. This schedule includes Standard Flats, Carrier Route, and High-Density, whose differences are not based on meaningful criteria, have been eroded by DPS processing, and are now being eroded further by FSS processing.[6] Differences among rate elements within the schedule exist. Honoring relevant workshare constraints, the Postal Service should be allowed latitude in selecting these various differences.

Nevertheless, Commercial flats as a category is "above water." The cost coverage for Standard Flats and Carrier Route combined, without Nonprofit, is

[6] Automated DPS'ed flat mail occurs only via the FSS, which, in the current year, sequenced 18 percent of all flats. Despite all the discussion on the FSS and its implications, it is important to remember that the vast majority of flat mail for the foreseeable future is not destined to be DPS'ed on the FSS.

114.0 percent, and even with pull-down from Nonprofit is 105.0 percent.[7] Both of these percentages would be higher if relevant flats paying High-Density rates were included. Again, the issue is relative rates within the *schedule* that applies to flats, which the Postal Service should have some freedom to control.

Even without bringing in Carrier Route, the cost coverage for Standard Flats is 84.9 percent with Nonprofit and 93.8 percent without Nonprofit. The former figure, which has received the most attention, is about 4 percentage points above the 2012 coverage. Moreover, the situation at year end was likely better than that. That is, the Postal Service is continuing to tighten operations. The coverage of 84.9 percent is an average for the year. If the trend during the year was upward, as we believe it was, the coverage at year end was in all likelihood higher than the average. This is a favorable outcome.

One other factor should be noted. Compared to FY2012, the volume of Commercial Standard Flats *decreased* 7.89 percent, the volume of Nonprofit Standard Flats *increased* 0.14 percent, and the volume of the two combined *decreased* 6.25 percent. There are two effects here. First, the fact that a greater proportion of Standard Flats is Nonprofit means that the low, Nonprofit rates have contributed to a lowering of the cost coverage. Consistent with this, the coverage of Standard Flats

[7] Costs and cost coverages for the Nonprofit categories, used in various calculations, are developed in USPS LR-27, which shows the cost coverage of Nonprofit Standard Flats to be 54.9 percent and of Nonprofit Carrier Route to be 87.1 percent. These coverages are based on assumptions about similarities between Commercial and corresponding Nonprofit categories.

It may be noted, though, that since, we believe, nonprofit mailers make relatively more extensive use of sacks, and the high costs of sacks are not separately recognized in these calculations, the cost coverages on the Nonprofit categories may be lower than shown. This would make the cost coverages on the Commercial categories higher than presented in the text.

without Nonprofit increased 5.3 percentage points relative to FY2012. Second, the fact that the sum of the two volumes decreased 6.25 percent added to the difficulty of achieving the overall increase in cost coverage of 4 percentage points. As stated above, this increase in coverage is a favorable outcome, and the behavior of the two component volumes makes it more significant than might at first be apparent.

Note also that focusing on the cost coverage of Standard Flats, including Nonprofit, puts nonprofit organizations in an unfavorable and disadvantaged position. Specifically, the more the Nonprofit volume increases, the greater the downward pressure on the cost coverage, which means, if there is any interest in keeping the cost coverage up, the greater the increase in rates they experience. In a sense, success brings about a penalty. It seems doubtful that Congress intended this kind of dynamic.

Despite all this awkwardness of concept and application, questions have been raised about whether the pricing of Standard Flats results in a cross-subsidy. This matter is discussed in the following section. Then a final section provides further perspective on matters relating to the validity of the costs. It can be viewed as a report on trends in unit costs.

A. Properly Framed, the Rates for Standard Flats *Cannot* Be Said to Involve a Cross-Subsidy.

Economists have been particular about how the notion of cross-subsidy is defined. Part of the problem has been to separate it from ordinary arguments that one rate is too high relative to another. Another part has been to base it on alternatives that are rational. Also, there has been concern that *all* of the effects of these alternatives should be considered, not just some of them.

The outcome has been a conclusion that a product (generic at this point) might be considered subsidized if complete removal of it from the list of product offerings of the firm would increase the profits of the firm. This requires that all repercussions of removal be considered.[8] In Postal proceedings, these repercussions have been called, for the most part, multiplier effects. Whether any increase in profits would lead to a reduction in the rates for another product is immaterial to the existence of a subsidy.[9]

Conclusions about subsidies are made more difficult by the presence of the Nonprofit categories. If Congress specifies substantially reduced rates for nonprofit organizations, in context understanding that they will be below-cost rates, it would not be appropriate to step back and say: "We have found that eliminating the Nonprofit product would improve finances, therefore a subsidy exists, therefore the rates should be increased." This would thwart the provision Congress had made.

So, if the subsidy question is to be asked, and a product offering is to be removed to see the effect on profits, exactly what product offering should be removed?

---

[8] In the literature, this test is referred to as the "Burden Test." It was developed to deal in a meaningful way with firms that have products that are interdependent. For further discussion of it, with references to the literature, *see* Initial Comments of ACMA, Docket No. ACR2011, February 3, 2012, at 31-32.

[9] In a competitive firm of the ordinary kind, any increase in profits from the removal of a subsidized product would accrue to the shareholders. Its other products are already being profit maximized, so they cannot be affected. If anyone, it is the shareholders that are funding the subsidy.

In a break-even organization, like the Postal Service was from 1970 to 2006, removal of a subsidized product would require the rates of some other product or products to be decreased.

Under a rate cap, which applies currently to the Postal Service, removal of a subsidized product would leave other products more directly linked to the cap than they were before. The freedom to allow them a rate decrease or a smaller rate increase would decline, at least so long as the firm is in need of improved finances.

In the past, attention has been focused on Standard Flats, including Nonprofit, excluding all repercussions. But it is hardly appropriate to include Nonprofit here, as explained above, or to exclude the repercussions.[10] Also, and more importantly, it makes no sense at all to remove Standard Flats and leave in place Carrier Route and High-Density. These latter two categories are nothing more than highly prepared forms of Standard Flats. Respectively, they were not even identified separately until 1979 and 1992. Alternatively, it would hardly be rationale to say: "We want to know the financial effects of removing ourselves from the processing and delivery of all Standard flats that are not prepared and submitted in bundles of at least 10 pieces per carrier route." They are all a portion of the very same mail drop.

Putting aside the question of whether to include Saturation and total-market-coverage flats in any analysis, a more reasonable question to ask would be: "What would be the effect on profits of removing ourselves entirely from the acceptance, processing, and delivery of all flats in the Standard class?" Since, as noted above, the cost coverage on this group is 105.0 percent, 114.0 percent without Nonprofit, and even higher when relevant flats in High-Density are included, the answer is that profits would decline, even before considering any repercussions. Properly framed, therefore, no subsidy exists.[11]

---

[10] Whether repercussions should be limited to multiplier effects is a good question. But even with this limitation, repercussion effects are difficult to quantify. However, difficulty of quantification does not make them irrelevant.

[11] Especially under a price cap, it can be tempting to argue that a subsidy exists when an increase in one rate would allow a decrease in another rate. But, except for unusually high elasticities, this is true at all times for all product categories, whether or not their revenues are greater than their costs. Therefore, this question has nothing to do with the notion of cross-subsidy.

Where does this leave the question of the cost coverage for Standard Flats, 93.9 percent and gaining, without Nonprofit? It is left at the same place we left it above: There can be disagreement about how the Postal Service selects the rate elements for the various categories of Commercial flats, and there can be opinions that the cost coverage for this grouping should be higher, but there is no subsidy that needs to be fixed.

B. Questions Still Exist about Whether the Costs Being Reported Are Sufficiently Robust to Provide a Basis for Evaluating the Cost Coverages.

When rates are changed, volumes (and associated revenues) change, which generally causes costs to change. The revenue and cost changes affect profits. Costing exercises are to quantify the effects on costs of the volume changes. The volume increment here is usually rather small.

Discussions of costing are often couched in terms of the short-run and long-run notions of economic theory. The short run focuses on effects of volume changes within a fixed plant, and the long run on effects when a new plant (including network) is built from the ground up to produce at new volume level. Changes of the latter kind tend to occur in the economy over time, to deal with which economic theory was mostly developed, but volume changes within the Postal Service are not accommodated by tearing down old plants and building new ones, especially when Congress periodically freezes the infrastructure with moratoriums.

Postal costing adopts a long run that focuses on *full adjustment* to volume changes. The view is that the lowest-cost way to accommodate a volume change is by adjusting *all* inputs, in an unconstrained way, *as though* sufficient time were available.

The result is costing algorithms that are used until they are replaced in a costing proceeding, which could be a considerable period of time.

The behaviors of algorithms of this kind vary. Following a volume increase, the algorithms may attribute overtime and inefficient operation,[12] until such time as more comprehensive changes are made to accommodate the new volume. The costs reported under these conditions are inefficiently high and not causal in a long-run sense.[13] Following a volume decrease, it is likely that resources are not yet adjusted, resulting in excess capacity, even in inputs that are normally viewed as variable. The algorithms then attribute the costs of this excess capacity. Again, the costs are inefficiently high and not causal in the desired sense. Here, however, as opposed to the case of a volume increase, the inefficiency may exist for some time, and it could be added to the next year.

It is not easy to determine when costs, as developed, are above the efficient level or when an estimation procedure is failing to give meaningful costs.[14] To help look into these questions, ACMA has developed a cost index.[15] [16] ACMA's index is easy to

---

[12] The usual notion is that when volume is pushing physical capacity, costs are unusually high due to an inefficient ratio of labor to equipment. Sometimes older, less efficient equipment is brought into use. In the Postal Service, sometimes manual processing is done. If in transportation, extra runs might be made.

[13] This outcome is consistent with the accepted conclusion in economic theory that short-run marginal costs are always higher than (or equal to) long-run marginal costs.

[14] Note that developing a new estimation procedure does not solve the problem, for this just presents the question of deciding whether the new procedure is better than the old one. When the "right" answer is not known, these questions are difficult.

[15] ACMA's cost index was presented in its Initial Comments in Docket No. ACR2011, February 3, 2012. It was discussed further in Comments in Docket No. R2013-1, November 1, 2012, Initial Comments and Surreply Comments in Docket No. ACR2012, February 1, 2013 and February 20, 2013, respectively, and Comments in Docket No. R2013-10, October 17, 2013.
*** footnote continued next page

calculate from readily available data, which makes it consistent with all those data.[17] The only party raising questions about it has been the Public Representative. Taking various turns, he has done this in reply comments and surreply comments.[18] In response, ACMA has explained that his comments are dominantly erroneous, and appear at many points to reflect a misunderstanding of the matters at issue.[19] Further, in its comments in Docket No. R2013-10 (October 17, 2013), ACMA provided a comprehensive review of several cost-index formulations.

---

footnote continued

An appendix in the latter comments showed mathematical relationships between the ACMA cost index and several other cost-index formulations.

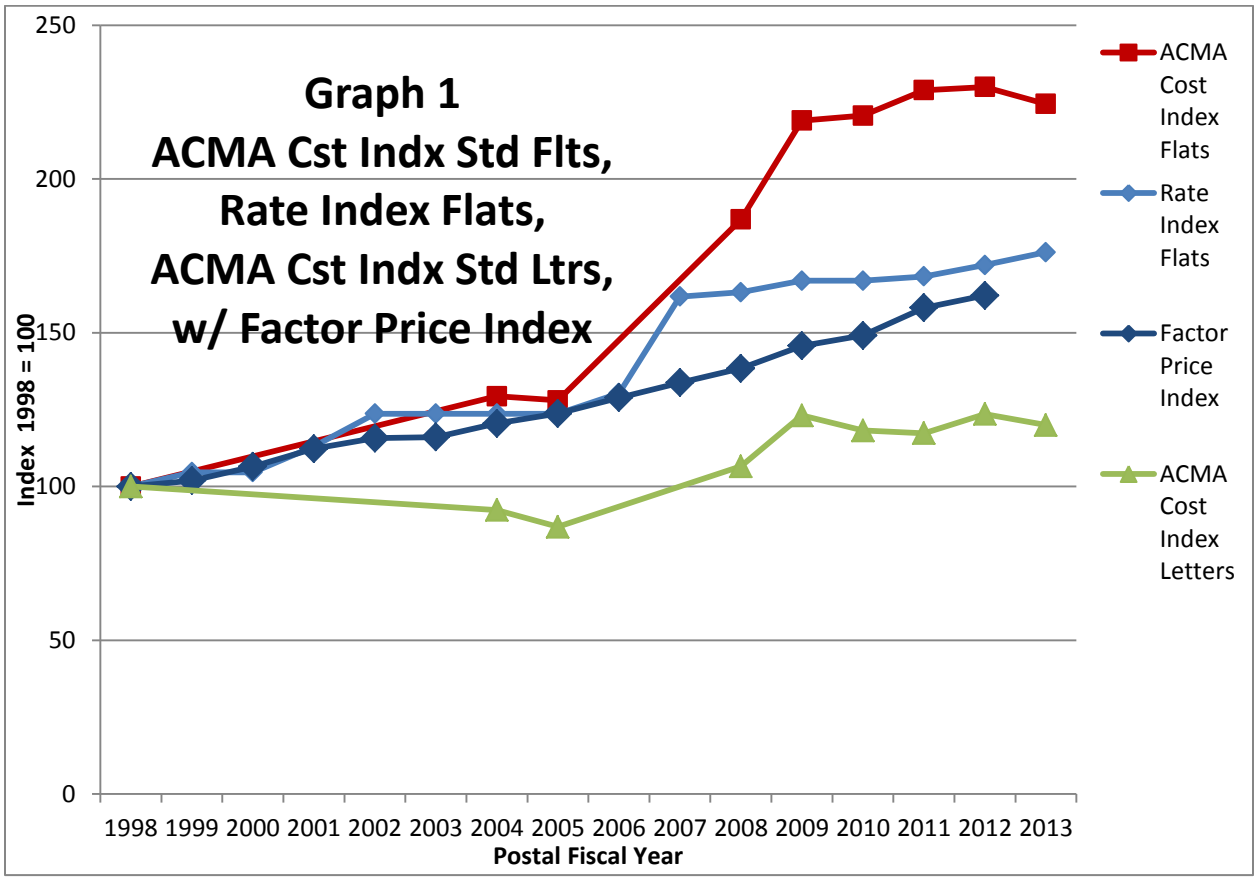
[16] The specific question of whether costs are above the efficient level is difficult to answer directly. ACMA's cost index make comparisons over time, which can raise questions and have implications. If costs rise much more over a period than can be explained, this would be consistent with costs being further above the efficient level than they were before. But trends over time being satisfactory would not necessarily argue that the costs are *at* the efficient level. Another way to look into the matter is to compare productivities among offices and processing facilities. If some are found to be surprisingly low, finding the reasons might be informative and helpful, including the possibility that corrections might be needed. On this point, see the discussion in the R97-1 Opinion and Recommended Decision (May 11, 1998, at 116, ¶ 3115) concerning testimony that "if the productivity of the top 25 percent of mail processing facilities were achieved by the remaining 75 percent, it would reduce mail processing costs by 20-25 percent." The same situation is believed to exist today.

[17] The ACMA cost index is calculated from the rate indexes developed by the Commission and the cost coverages from the Compliance Determinations. The rate indexes are 100 percent detailed in that they include all rate elements and a complete set of billing determinants. The cost coverages carry the full detail of the costing system. Therefore the ACMA index is as granular as the systems allow and does not introduce approximations.

[18] *See* Public Representative Reply Comments, Docket No. ACR2011, February 17, 2012, pp. 9-16; Public Representative Reply Comments, Docket No. ACR2012, February 19, 2013, pp. 27-31; and Public Representative Response to Surreply Comments of the American Catalog Mailers Association, Docket No. ACR2012, February 27, 2013.

[19] *See* Comments of the American Catalog Mailers Association (ACMA), Docket No. R2013-1, November 1, 2012, pp. 8-10 and Appendix II; and Surreply Comments of the American Catalog Mailers Association (ACMA), Docket No. ACR2012, February 20, 2013.

What Does the Cost Index Show? Graph 1 shows the ACMA cost index for Standard Flats and Standard Letters, along with a rate index for Standard Flats and a factor price index.



This graph shows that since 1998, the unit cost of Standard Flats, corrected for growth in worksharing, has increased 124.4 percent while factor prices have increased about 64 percent.[20] The increase in unit cost for letters has been only 20.0 percent. Over the same period, the *rates* for Standard Flats increased 76.2 percent. With a string of technical changes and improvements in mail preparation over this period, one

[20] The factor price index is contained in the annual TFP report, which is not yet available for 2013. The 64-percent figure in the text is an estimate based on apparent trends.

would expect the unit costs to rise less than the factor prices. The decline in cost coverage for Standard Flats is explained fully by the increase in unit costs (124.4 percent) being larger than the increase in rates (76.2 percent). In previous proceedings, ACMA has discussed these results in some detail, making the case that much of the increase in unit costs is due to the attribution of the costs of excess capacity.

For present purposes, however, it is important to note the significant downturn in unit costs in 2013 for both letters and flats. The cost index for Standard Flats is down 5.5 percentage points (on a 1998 base), in the face of a likely increase in factor prices and a volume decline of 6.3 percent. This is a noteworthy accomplishment. It indicates a tightening of operations and a reduction in excess capacity, consistent with ongoing Postal Service efforts. Since there is much work to do yet, one would expect a further reduction in unit costs next year and thereafter.

II. CONCLUSION

Though designated as a separate product, Standard Flats is a reasonably small, declining part of a schedule of rates provided by the Postal Service to for-profit and not-for-profit mailers of flats. The schedule includes the categories of Standard Flats, Carrier Route, and High-Density, and functions as a continuum. As explained in these comments, the finding of this Compliance Review should be that the rates for Standard Flats are satisfactory; they are not in violation of title 39 U.S.C.

The rates in the flats continuum cover their costs, even after being pulled down by the Nonprofit categories. An appropriate cross-subsidy test does not show the flats in this continuum to be subsidized. There is a supportive dependency between these

flats and other mail products, often referred to as a multiplier relationship. And serious, unanswered questions exist about the validity of the costs behind any concerns about Standard Flats.

In effect, the Postal Service should be accorded flexibility to select the various rate elements in the schedule of rates presented to flats mailers. The differences among these elements are important to mailers and the Postal Service. No one else is in a position to manage them.

Respectfully submitted,

The American Catalog Mailers Association, Inc.

Hamilton Davison
President & Executive Director
PO Box 41211
Providence, RI 02940-1211
Ph: 800-509-9514
hdavison@catalogmailers.org

Robert W. Mitchell
Consultant to ACMA
13 Turnham Court
Gaithersburg, MD 20878-2619
Ph: 301-340-1254
rmitxx@gmail.com